Why left-wing moralists and right-wing academics are wrong about Asia

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Abstract:
The 1980s witnesses an international debt crisis that began in Mexico and quickly spread throughout Latin America and then to parts of Asia and Eastern Europe. The crisis was triggered in mid-1982 and took 7 years to resolve. Central to that resolution process was a distinction between illiquidity and insolvency. None of the Asian economies is in any meaningful sense insolvent, and those who oppose the IMF-led bailout fall into 3 equally misguided camps - fiscal conservatives, left-wing moralists, and right-wing academics. Mismanagement in many developing economies (although not in South Korea) took the form of prolonged commitment to overvalued, fixed exchange-rate regimes. This in turn generated excessive current account deficits, financed by unsustainable capital account surpluses. In summary, the crisis in Asia was precipitated by currency attacks on overvalued exchange rates, but fundamentally rooted in the massive misallocation of both domestic savings and borrowed foreign funds by domestic banking systems.

Full Text:

Asia has a liquidity problem, not a solvency problem.

The 1980s witnessed an "international debt crisis" that began in Mexico and quickly spread throughout Latin America and then to parts of Asia and Eastern Europe. The crisis was triggered in mid-1982 and took seven years to resolve. Central to that resolution process was a distinction between illiquidity and insolvency (first emphasized by William Cline). If sovereign borrowers were simply illiquid, it was argued, policy should center on "liquidity relief": rescheduling debt and lending additional funds. If they were insolvent, it should center on "debt relief": that is, permanent reduction of debt obligations. Ultimately, liquidity relief proved insufficient, and the crisis was resolved with the so-called Brady Plan that included substantial debt reduction by commercial bank creditors.l

In 1994-95, a second Mexican crisis erupted that was correctly deemed to be a liquidity crisis and rather adeptly resolved through a massive and unprecedented infusion of funds from the U.S. Treasury and the International Monetary Fund (IMF). That crisis was more or less confined to Mexico, albeit with some tremors transmitted to Argentina. In short, the crisis proved both transitory and local.

In mid-1997 there was a currency crisis in Thailand that spread almost overnight to Malaysia, Indonesia, and the Philippines. Within weeks the IMF, joined by other multilateral and bilateral lenders, had committed $24 billion to Thailand and $32 billion to Indonesia. But not until November 1997 did the crisis hit Asia's third-largest economy, South Korea, where the impact was far more dramatic than expected. The won fell repeatedly by 10 percent per day, the limit of its trading band; several major firms were declared insolvent; and by mid-December smaller firms were failing at the rate of fifty per day. Short-term interest rates soared to 30 percent and above. The IMF, World Bank, Asian Development Bank, and governments of eleven countries committed $57 billion to a rescue package, dwarfing the packages already committed to Thailand and Indonesia, not to mention the record-setting 1995 Mexican bailout.

As is its practice, the IMF attached strenuous conditions to its South Korean loan package, including the closure of firms and financial institutions deemed to be insolvent and sharp hikes in interest rates. This latter part of the package is highly controversial (see, for example, Sachs, 1997). Indeed, as of mid-January 1998, the relevant Asian economies are continuing to deteriorate, and deteriorate substantially, despite-or, some would say, because of-the IMF programs. While substantially higher interest rates might attract and retain capital inflows from abroad, they have failed to do so. But higher interest rates have increased debt-service obligations on outstanding debt. In some cases, such increases might have been sufficient to push firms and financial institutions that were hitherto simply illiquid over the brink into insolvency, especially since the debt-equity ratios-especially in Korea-are extraordinarily high by international standards. This line of argument suggests that macroeconomic conditions being imposed by the IMF are dead wrong.2 It may also suggest that other harsh (but necessary) aspects of the program, such as closures of insolvent banks and firms, should be subordinated to its "bailout" dimension, at least for the moment.3 Indeed the chief economist of the World Bank, Joseph Stiglitz, is remarkably critical of his sister institution's policies in Asia: "You don't want to push these economies into severe recession. One ought to focus on the things that caused the crisis, not on things that make it more difficult to deal with."4

A second line of argument suggests the reverse: that bailouts should be subordinated to conditionality. Because misguided internal allocation of credit created the difficulty for Asian countries, no bank or firm in a borrowing country should be shielded from bankruptcy by IMF or other official bailouts, even temporarily, nor should foreign lenders be spared the consequences of their past folly. To do otherwise would be to generate even more unwarranted optimism about risk (what economists call "moral hazard") than was generated by the Mexican relief package of 1995. Paul Krugman, while stopping short of endorsing this view in its extreme, has recently given it implicit support with an analysis of the underregulated and overcomforted Asian banks' "Panglossian" overlending (Krugman, 1998). According to Krugman, the rot began in Japan during the 1980s, and progressed to the "little tigers" in the 1990s.

The two sides of this debate ascribe the failure of the IMF's Asian programs to stem capital flight and currency collapse to virtually opposite causes: one side to excessively harsh (macroeconomic) conditionality that has led to unnecessary bankruptcies, and the other side to excessively lax conditionality that has kept ill-conceived enterprises alive for too long.

This article places the debate between prescribing illiquidity or insolvency in historical perspective by comparing Asia's current debt crisis with Latin America's during the 1980s. It is then suggested that none of the Asian economies is in any meaningful sense "insolvent" and that those who oppose the IMF-led "bailout" fall into three equally misguided camps-fiscal conservatives, left-wing moralists, and right-wing academics. This is not to suggest that the IMF's response to the Asian crisis has been flawless: It has not. IMF conditionality has wrongly emphasized macroeconomic frugality, prescribing fiscal, monetary, and growth targets that may have been appropriate for Latin America in the 1980s but ignore the reality of an already frugal Asia in the 1990s. The article concludes that whereas currency crises and consequent illiquidity in Thailand, Indonesia, and Malaysia were arguably of their own making, South Korea's currency crisis spread irrationally from the others' and was compounded by what this author calls "reverse free-rider" phenomenon among foreign lenders. Withholding liquidity relief now risks turning mere illiquidity into genuine insolvency. (Korea's debt history between 1960 and 1989 is outlined in the box on the next page.)

Illiquidity or Insolvency in the 1990s?

The first major post-Brady international payments problem was the Mexican crisis of 1994-95. In retrospect, it was clearly a crisis of illiquidity rather than insolvency. Mexico's payments problems were resolved with the help of a $40 billion line of credit from the U.S. Treasury and the IMF that was only partially drawn on and repaid, ahead of time and at market rates of interest, within two years. Will the verdict on the present crisis in Asia be so straightforward?

To answer this question, it is instructive to compare broad features of the current crisis with those of the 1980s. The 1980s crisis was triggered by a rise in international interest rates that virtually doubled debt-service payments. This was compounded by decline in developing-country export revenues as a result of recession in the major developed economies. No such external events triggered the Asian crisis of 1997. It is true that the rise in value of the U.S. dollar against the Japanese yen and the German mark over the past year hurt exports of Asian countries whose currencies were pegged to the dollar. But the impact of this event on current accounts was nowhere near as dramatic as the sharp hike in international interest rates from 1980 to 1982.

The two crises, however, were similar in the way that they spread beyond their origins. The 1980s crisis spread rapidly from one country (Mexico) to most of Latin America because new lending to other heavily indebted developing countries dried up almost overnight. Similarly, the crisis of 1997 spread rapidly from Thailand to half a dozen other Asian countries because of the contagious cessation of capital inflows.

The 1980s crisis was greatly magnified in many, but not all, affected countries by massive domestic capital flight, both before and after the onset of the crisis itself. This was not a problem in Asia during the 1980s (except in the Philippines). Nor does it appear to have been a problem leading up to the 1997 crisis, although the crisis itself has been marked by substantial shifts of domestic funds into Asian-based branches of foreign banks, including shifts into foreign-currency deposits.

The 1980s crisis was curtailed initially via a strategy of concerted liquidity relief, involving coordinated new lending as well as payments rescheduling by commercial banks and by bilateral and multilateral lenders. The banks in particular perceived this strategy to be in their short-term interest since it would "defend" the long-term prospects of receiving repayment of their outstanding debt claims. In due course, this strategy became both less wise and less workable as debt claims accumulated and arrears mounted. In short, as illiquidity slid toward insolvency, the rationale for supplementing liquidity relief with debt relief became correspondingly more compelling.

Thus far in the Asian crisis, liquidity relief from private lenders has proved more problematic than it was in the early stages of the crisis of the 1980s. Unlike in the 1980s, borrowers are no longer sovereign states; they are from the private sector. They are also diverse, thus lenders cannot so readily negotiate with them as with a single sovereign borrower. Moreover, capital inflows during the 1990s have been dominated by direct investment and portfolio flows, rather than by commercial bank lending. Because portfolio debt and equity are widely held, rather than concentrated as unsecuritized loans in the hands of a few large banks, incentives to defend outstanding claims are widely disbursed and less imperative from the standpoint of individual claimants (Dean, 1995). When portfolio capital is short-term, as much of it is, the incentives for what might be called "reverse free-rider" behavior are high: if an individual investor sees other investors pulling out, that alone is an incentive for him to pull out, irrespective of the merits of the investment itself. As George Soros put it recently, "We are dealing with a self-reinforcing process" (Soros, 1997).5 The free-rider barrier to reinvesting short-term portfolio capital is very difficult to overcome. Perceived shortfalls become actual shortfalls, and perceptions of liquidity crises become self-fulfilling.

Probing beneath the liquidity squeeze, debtor countries in both the 1980s and the 1990s indulged in macroeconomic mismanagement. Because sovereign states were the primary holders of foreign debt in the 1980s, macroeconomic mismanagement took the form of inflationary finance and accumulation of domestic debt under the pressure of a fiscal "internal transfer problem." Even microeconomic mismanagement was often a consequence of government policy, since state and parastatal enterprises borrowed for their own accounts and bore responsibility for misallocated credit and squandered funds.

Macroeconomic mismanagement in the 1990s assumed different forms. Excessive fiscal deficits and inflationary finance were by and large phenomena of the past. Rather, mismanagement in many developing economies (although not in South Korea) took the form of prolonged commitment to overvalued, fixed exchange-rate regimes. This in turn generated excessive current account deficits, financed by unsustainable capital account surpluses. When the latter put pressure on domestic money supplies and caused inflationary pressure, borrowing countries often attempted to sterilize their effects. This in turn tended to raise domestic interest rates and attract further capital, as well as incur quasi-fiscal costs. As inflation proceeded at rates above their trading partners', borrowing countries' real exchange rates became increasing overvalued. A corollary was that real interest rates turned negative, at least for those willing to borrow in foreign currency on the assumption that nominal exchange rates would not be devalued. In short, both Mexico in 1994 and a range of Asian countries in 1997-notably Thailand, Indonesia, and Malaysia, but not South Korea-were poised for exchange rate crises.

Microeconomic mismanagement in the 1990s took the form of serious credit misallocation by domestic banks and other private financial institutions. This misallocation occurred either because of benign neglect by government (inadequate supervision and regulation), as in Thailand; a combination of neglect and self-interested involvement by government, as in Indonesia; or direct but misguided involvement by both government and industry, as in Korea. In short, Asia-Pacific countries in 1997 were vulnerable to banking and financial crises. But contagious exchange rate crises were the triggers.

Differences from the 1980s help explain why the liquidity crisis this time has been more severe and prolonged, but they hide a paradox. The most fundamental difference between the Asian economies now and Latin America's then is that Asian economies are stronger on the supply side. They have high savings rates, a strong work ethic, a highly educated labor force, and high productivity built on non-resource-based activity. Although it is true that they have overinvested and misallocated capital, this does not spell "insolvency" in the long run provided that they submit themselves to medium-term structural adjustment. Finally, the demand side of Asian economies-except for excessive current account deficits in Thailand, Malaysia, and Indonesia-has been well managed, with low inflation and small fiscal deficits.

In short, Asia today differs from Latin America fifteen years ago in that it is simultaneously more prone to illiquidity and less to insolvency Not that Latin America was ever "insolvent" in a strict sense; but, for practical purposes, it became sufficiently insolvent fiscally that debt relief was warranted. It is inconceivable that Asia will ever reach that point: inconceivable, that is, unless we the creditors so mismanage our liquidity relief that we precipitate insolvency unnecessarily. The potential for such mismanagement was evident during the final weeks of 1997, as large banks met in emergency sessions to negotiate debt relief for Korea.

Liquidity Management by South Korea's Creditors

Despite a shift toward portfolio finance in the 1990s, large banks do hold substantial claims on Asia and on Korea in particular. It is between them that a coalition must emerge if liquidity relief from private lenders is to be forthcoming. Japanese banks, for example, hold almost $24 billion in claims on South Korea. But, in practice, with Japanese banks short of capital and ridden with non-performing domestic loans, liquidity relief has been hard to muster. Indeed, during the last few weeks of 1997 commitments by the Japanese banks simply to roll over existing shortterm loans were accepted by Korea and other borrowers with sighs of relief. Negotiation of new or longer-term commitments, or of rescheduling, was painful. As a result, Korea had to rely on unprecedently large and quick disbursements from the IMF However, on December 25, in an apparent effort to induce belated participation by commercial banks, the IMF, the United States, Japan, and nine other countries announced plans to accelerate disbursement of $10 billion in new loans to Korea. Within a few days this strategy was promising to pay dividends. On December 29, executives from thirteen large U.S., Canadian, Japanese, and European commercial and investment banks met at the Federal Reserve Bank in New York City to discuss rollovers, rescheduling, and new loans. The immediate objective was to inject sufficient short-term liquidity to enable South Korea to meet about $15 billion in loan repayments over the coming month. This objective was in fact met within days of the December 29 meeting, when the major commercial bank creditors, led by Citibank, agreed to roll over their claims for another thirty days.

The next objective was to restructure South Korea's debt on a much longer-term basis and preferably attract new loans as well. By the first week of January 1998, the banks' initial reluctance had rather ironically metamorphosed into moderate competition between commercial and investment banks for pieces of the bailout pie. With J.P. Morgan in the forefront and Goldman, Sachs and Salomon Smith Barney close behind, proposals began to emerge for securitizing existing commercial bank debt as longer-term, tradable bonds and for raising new money by issuing new bonds. Not incidentally, these proposals promised to earn their investment bank advocates tens of millions in fees, as well as relieve the commercial banks of their exposures. The banks also called for Korean government guarantees on such bonds, thereby virtually guaranteeing that they would profit from their ill-considered past lending. Despite their obvious potential for moral hazard, such guarantees may be necessary (and are apparently favored by the IMF) since the bulk of Korea's borrowers were banks. Failures of these Korean banks would likely be multiplied into failures of chaebols (conglomerates) as well as other, smaller firms in the real sector, on a magnitude too terrible to contemplate. In short, the strategy as of early 1998 was to convert short-term commercial bank loans to Korean banks into long-term bonds guaranteed by the Korean government.

For its part, the Korean government was not about to provide guarantees without hard bargaining. Accordingly, by early January 1998, the president-elect, Kim Dae Jung ("D.J.") had dispatched a negotiating team to New York and Washington. The Koreans stressed that the debt-restructuring package must include new syndicated commercial bank loans to the government, in order to replenish foreign exchange reserves. In a somewhat bizarre twist, it emerged that in late December 1997 the South Korean government had retained E. Gerald Corrigan, a former president of the Federal Reserve in New York and currently a partner at Goldman, Sachs. Corrigan was retained as an "independent adviser": so independent, in fact, that he was bound by the terms of his contract not to communicate his dealings to Goldman, Sachs. "If you open up someone's eyes to the possibility of restructuring their debt, there's no reason for them to think they can't do it themselves," one American banker reportedly said, on condition of anonymity (New York Times, January 5,1998, p.1).

Conclusion

In summary, the crisis in Asia was precipitated by currency attacks on overvalued exchange rates, but fundamentally rooted in the massive misallocation of both domestic savings and borrowed foreign funds by domestic banking systems. It is important to distinguish conceptually between exchange rate crises and credit misallocation crises because the two have become intertwined as the banking and financial crises. Herein also lies the importance of distinguishing between illiquidity and insolvency. Exchange rate collapses have led to severe liquidity squeezes in both the financial and the real estate sectors. These have been exacerbated by the free-rider barrier to resumption of portfolio capital inflows from abroad and the reluctance until several months into the crisis of major foreign banks to mobilize rollovers, rescheduling, and new lending. The fact that it took several months to negotiate private relending has confronted Asian economies with the clear and present danger that a largely nominal exchange rate and financial crisis will deepen into a credit crisis with severe real consequences. In short, Asian economies, or at least Asian firms, are in danger of being pushed from illiquidity into unwarranted insolvency.

Because illiquidity has been so extensive and life-threatening, official lenders-the IMF, the World Bank, and bilateral lenders-have had to play an unprecedentedly large role. This role has come under attack from three quarters: from fiscal conservatives (for example, elements in the U.S. Congress) who fear the cost, from left-wing moralists who inveigh against bailing out big banks, and from right-wing academics who fear moral hazard. All three are misguided. Fiscal conservatives fail to understand that the IMF's "bailout" is nothing of the sort. The IMF package is a commitment to disburse a series of loans on an asneeded basis at market rates of interest, loans that will almost certainly be repaid on time: unless, paradoxically, the opponents of such loans prevail. Left-wing moralists have a point, but at this delicate juncture it must be tempered by pragmatism. Moreover, the South Korean negotiating team is tough and well-advised and can be counted upon not to concede more to the banks than is in Korea's own self-interest. Right-wing academics also have a point, but once again, pragmatism must prevail, at least for the short term.

The challenge now is to forestall further real damage, while attaching strong enough conditions to the loans to ensure that past mistakes are both rectified and rendered unlikely to recur.

The challenge for official lenders is to distinguish between banks and firms that are genuinely insolvent and those that are simply temporarily short of funds. This is compounded by the fact that both banks and firms, especially in South Korea, have debt-equity ratios far in excess of international norms. The immediate challenge for the IMF, in particular, is to ensure that liquidity relief is allocated exclusively toward banks and firms with the potential for long-term solvency, while maintaining pressure to restructure, consolidate, or close the rest. A further challenge is to make official funding conditional on rupturing cozy relationships between government and industry, and on radical and permanent reforms of bank regulation and supervision. In accomplishing this task, the IMF faces further dilemmas given the political resistance that such reforms will encounter in Asia and given that withholding funds profoundly endangers the international financial system.

To some extent these dilemmas will be eased by the willingness of foreign direct investors to inject equity into failing enterprises, but such investment, again particularly in Korea, must be preceded by rapid liberalization of restrictions on foreign ownership. For example, despite recent easing of restrictions on inward foreign direct investment, South Korea as of late 1997 still prohibited foreign direct investment by means of mergers and acquisitions. Needless to say, domestic restructuring and foreign control will encounter strong popular and political opposition.6

Although all four failing Asian economies are tarred by the same brush of overinvestment and capital misallocation, it is important to emphasize that in several respects, South Korea is less culpable. Although it overborrowed and overlent on a massive scale, South Korea is not (as President-elect Kim rather inappropriately remarked early in the crisis) "bankrupt." It is illiquid merely because of a financial panic that spread from other Asian countries and was compounded by a reverse free-rider phenomenon. South Korea's external debt of about $160 billion is not high, either relative to the country's gross domestic product (GDP) or relative to a decade ago. However, the fraction of external debt that is short-term, coming due within a year or less, is dangerously high-comprising about two-thirds of total external debt. Until early 1998, when lenders belatedly agreed to roll over debt until March, roughly $15 billion was maturing every month.

What occurred during the last two months of 1997 might be called a reverse free-rider phenomenon. Prompted by the problems in other Asian countries, speculators, short-term lenders, and portfolio investors began to bet against the Korean won, exhausting much of Korea's foreign exchange reserves in the process. Short-term lenders then noted that at least $100 billion in external debt was due to mature within one year, and that the IMF package of $57 billion, together with official reserves of less than $10 billion, fell far short of closing the gap. It was quite rational for individual short-term lenders not to renew, even though collectively it was very much in their interests to do so since that would close the liquidity gap and end the immediate crisis. As in the crisis of the 1980s, concerted liquidity relief from private lenders was crucial to preventing widespread insolvency. The hole in the dike had to be plugged before the whole dike collapsed.7

For the past decade or more, South Korea's macroeconomic management has been fundamentally sound, with low inflation, low fiscal deficits, a relatively low current account deficit (2-3 percent of GDP), and, in fact, a trade surplus in late 1997. Moreover, unlike in Thailand, Malaysia, and Indonesia, the real exchange rate in Korea was not overvalued. Before the won collapsed, Korea's real effective exchange rate was some 5 percent lower than in the early 1990s, and the real rate against the U.S. dollar was 25 percent lower! The IMF must be cautioned against demanding unrealistically low inflation targets for 1998, since that would imply a "brutal monetary squeeze" (Sachs,1997) in the context of the won's recent depreciation by more than 50 percent. This caution is especially acute in the context of the extraordinarily high debt-equity ratios prevalent among Korean firms.

Despite the soundness of the country's macroeconomics and the spurious nature of South Korea's present financial panic, there is no denying serious microeconomic problems stemming from massive, bank- and government-abetted misallocation of capital and a correspondingly irrational industrial structure with overdiversified chaebols at the core. This is the legacy of an underregulated and overcomforted banking system that indulged in "Panglossian" lending practices, reinforced by easy money from abroad-a system that must, and now will, be reformed. But those who bemoan such practices in the past are quite wrong to argue that the IMF and the world's major banks should now pull the plug on South Korea. This is not the time to agonize about moral hazard.

Notes

1. For extensive reviews of the 1980s international debt crisis, see Bowe and Dean (1990, 1997b), Cline (1995), and Dean (1992).

2. Indeed the IMF has already admitted to excess harshness in at least one case. In the fall of 1997, the IMF forced closure of twelve financial institutions in Indonesia. This led to a run on banks that immediately worsened the crisis. In early January 1998, an internal IMF document admitting error became public. 3. I use the word "bailout" advisedly The $24 billion, $32 billion, and $57 billion packages put together for Thailand, Indonesia, and Korea are commitments to be drawn upon only as needed to meet sovereign obligations, notably to supplement foreign exchange reserves depleted in defending plummeting exchange rates (although, as the crisis deepens, it seems increasingly likely that the full commitments will be drawn upon). They are also market-rate loans, not grants, and are thus bailouts of the debtor countries only if and when they are not repaid (and historically the IMF has almost always been repaid). However, they are indirect bailouts of foreign banks and other private creditors.

4. As quoted in the International Herald Tribune, January 16,1998, p. 11. 5. In the same Financial Times editorial, Soros calls for the formation of an "International Credit Insurance Corporation" to supervise and regulate the allocation of international capital. While not an entirely new suggestion (see Cline's advocacy of an "International Bondholders Insurance Corporation" [1995, pp. 482-93]), Soros's proposal may well fall on receptive ears, given its timeliness in conjunction with his power and prestige.

6. Debt restructuring can be explicitly linked with foreign direct investment through debt-equity swaps. This mechanism flourished and helped ameliorate the immediate problems of at least a dozen troubled sovereign debtors during the mid

1980s (Bowe and Dean,1993,1997a,1997b). As of January 1998, proposals for debtequity swaps have not been broached in the South Korean context.

7. I am indebted to my Western Washington University colleague, Dennis R. Murphy, for the metaphor of the dike.

8. Frequent banking and financial crises in countries that have recently liberalized their internal and external controls on interest rates and capital flows have led some to question the appropriate sequencing of financial liberalization: for example, whether completely unrestricted capital inflows and outflows ought to be introduced before proper bank supervision and regulation is in place (see Dean, 1997).

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